REGULATION AND TECHNOLOGY

The European banking purge

The European banking landscape continues to evolve post the global financial crisis. **Paul Burdell** of LCM Partners discusses the impact this is having on European credit, NPL investment opportunities and how technological disruption is creating new openings for private debt funds

With over 19 years in the provision of private debt solutions, LCM Partners is well equipped to understand how the market has developed not just in the last five years since *PDI* launched, but since the turn of the millennium. We caught up with the firm's group CEO Paul Burdell to talk about the aftershocks of the financial crisis, the existential challenge facing the banks and the opportunities that can open up for private debt investors with the right knowhow and technological infrastructure.

Q How has the European credit market evolved over the past five years?

PB: The European credit market has changed dramatically, particularly if we look back beyond the last five years to the global financial crisis. Since 2008 we have seen banks receiving unprecedented support through quantitative easing and various interventions by national governments to keep their major institutions afloat.

Nonetheless, it remains difficult to be a bank these days, and there are two main forms of pressure that they face right now.

Following the crisis, banks had a large number of non-performing loans (NPLs) on their books that they were not forced to address as a result of all the government and regulatory support. What we've seen more recently is a gradual tightening of the rules by both the European Central Bank (ECB) and politicians in Brussels which is finally forcing the banks to deal with these loans. This delayed purge of NPLs will help the banks to drive greater balance sheet efficiency and focus on the assets where they can generate strong risk-weighted returns.

Paul Burdell

"OVER THE LAST DECADE ALL BANKS HAVE BEEN TARRED WITH THE SAME BRUSH – THAT THEY ARE POORLY CAPITALISED, SHORT-TERMIST AND APATHETIC WHEN IT COMES TO THEIR IMPACT ON CUSTOMERS AND THE WIDER ECONOMY"

The other source of pressure comes from the technological developments since the financial crisis which have allowed a number of disruptors to come into the space traditionally occupied by banks. Some of the small shadow banks that have emerged after the crisis are, today, becoming quite large. Furthermore, because they built their businesses from scratch, they have the added advantage of not having legacy systems or portfolio issues which makes it easier for them to navigate their way through the current regulatory-heavy environment.

Q Regulation has been a huge theme for the past decade. What in particular has forced this change in bank behaviour?

PB: In a nutshell - the financial crisis. In the past it used to be simple. A bank's purpose was to make returns for its shareholders. Today, from a shareholder's point of view, nothing has changed but the constraints that banks now operate under mean that the objective of "profit above all else" has vanished and a huge array of other factors have to be considered including softer concepts such as "treating customers fairly" as well as the hard hurdles of significantly enhanced capital ratios. These are coupled with hugely more intensive levels of consistently-applied supervision and potential intervention from regulators, amongst a long list.

It's not too hard to understand why this has happened. Over the last decade all banks have been tarred with the same brush – that they are poorly capitalised, short-termist and apathetic when it comes to their impact on customers and the wider economy. While these are generalisations and stereotypes, they are a direct consequence of the disastrous performance of many US securitisation bonds which led to many billions of pounds and euros and dollars of taxpayer funds being injected into the banking sector.

While these bail-outs may have been unavoidable, they caused policymakers to completely revise their approach to their banks' activities - and the regulation of those activities - in an attempt to ensure that the sector would have sufficient resilience to mean that the use of public funds would be a last resort in future instead of the first and only option. Many of the changes that have been introduced by Basel III, the European Central Bank, the International Accounting Standards Board and others were necessary and addressed systemic weaknesses that were exposed by the crisis.

There is a very strong argument to be made that some regulations have gone too far and are inhibiting the very behaviour we wanted to see from the banks. Unfortunately there's little to be gained for politicians or authorities being seen to be standing up for the "big bad banks" by questioning the wisdom of these new rules. The flip side however is that these regulations are driving many of the opportunities that we are seeing in the private debt market.

Q What effect has this had on competition in the debt market?

PB: When it comes to acquiring NPLs, competition is very high although it varies considerably between different markets. Right now, Italy is extremely competitive because it's the largest NPL market and the issues facing the Italian banks have been well documented in the press. We've been operating in Italy since 2006 and have learnt that the quality of the transactions there does vary wildly. This means we are taking a cautious approach with a focus on acquiring higher quality portfolios where the vendor is providing a sufficient amount of data for us to perform our due diligence.

"THERE IS A VERY STRONG ARGUMENT TO BE MADE THAT SOME REGULATIONS HAVE GONE TOO FAR AND ARE INHIBITING THE VERY BEHAVIOUR WE WANTED TO SEE FROM THE BANKS. UNFORTUNATELY THERE'S LITTLE TO BE GAINED FOR POLITICIANS OR AUTHORITIES BEING SEEN TO BE STANDING UP FOR THE 'BIG BAD BANKS' BY QUESTIONING THE WISDOM OF THESE NEW RULES"

Outside of Italy, while it is still competitive, we continue to see attractive investment opportunities in our other core markets, such as the UK, Spain and Germany. Increasingly, we find it helps that the sellers know us well as we have been an ever-present buyer in these markets for the last decade.

Looking at the impact of the technology disruptors on the banking sector, there are some really interesting opportunities for debt funds to actually work with the banks and help them to compete with these disruptors. We can complement the banks in two ways; by doing the business which the banks don't want to do themselves, but which their customers are demanding, and by doing the kind of business that banks simply can't do anymore because of the regulatory and business pressures they now face.

Q What are you most looking forward to in 2018?

PB: As regulation begins to bite we will see a lot more opportunities with NPLs coming onto the market. We are looking forward to what is undoubtedly going to be a busy year.

We are also looking at opportunities outside of the NPL space. We've been investing in both performing and non-performing loans for a long time, and we are using this knowledge together with our servicing infrastructure to provide innovative solutions in other segments of the private debt market.

Our new direct lending fund, SOLO 1, not only provides innovative financing solutions but, for those institutions that have the legacy technology issues which I mentioned earlier, LCM's sister company has an operating platform which can provide the infrastructure and proprietary systems to support the origination and loan management. The opportunity set for SOLO 1 is huge and when we look into the future and further afield, for example into Asia and beyond, the numbers are even more staggering.

Of course, it's the kind of business where it's not enough simply to appear with a cheque book and provide some capital; it requires a lot of knowhow and a lot of technological expertise. It also requires a real partnership mentality in order to forge long-term relationships with originators and provide them with the kind of solutions they need to keep their customers happy. ■